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In The

Supreme Court of the United States

October Term, 1995

SEYMOUR J. RYCKMAN, DAVID B. BLOOM, JERRY M. FRIEDMAN, JAMES NULL and THE STATE OF CALIFORNIA,

Petitioners,

vs.

ENVIRODYNE INDUSTRIES, INC.,

Respondent.

Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether the principles of equitable subordination incorporated into § 510(c) of the Bankruptcy Code permit a bankruptcy court, in the absence of any inequitable conduct by a creditor, to subordinate that creditor's claim, valid under state corporations law, on the basis that the claim had its origin in an equity interest that the creditor had in a corporation purchased by the debtor's parent in a leveraged buy-out years before the debtor's filing of a petition in bankruptcy.

LIST OF ALL PARTIES

In addition to the parties shown as petitioners in thecaption of this case, the Illinois Department of Financial Institutions was a party-appellant in the proceeding in the Court of Appeals for the Seventh Circuit. None of the petitioners are corporate filers, so that no parent or subsidiary company need be listed.

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Petitioners, Seymour J. Ryckman, David B. Bloom, Jerry M. Friedman, James Null, and the State of California, petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-10a) is reported at 79 F.3d 579. The opinion of the district court (App., *infra*, 11a-27a) is unreported. The opinion of the bankruptcy court (App., *infra*, 28a-52a) is reported at 176 B.R. 825.

STATEMENT OF JURISDICTION

The judgment of the court of appeals was filed on March 15, 1996. The jurisdiction of the Supreme Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISION INVOLVED

The pertinent part of the subordination provision set forth in § 510(c)(1) of the Bankruptcy Code states that "after notice and a hearing, the court may under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest. . . ." 11 U.S.C. § 510(c)(1).

STATEMENT OF THE CASE

On September 23, 1993, the respondent, a debtor in a reorganization proceeding under Chapter 11 of the Bankruptcy Code, commenced an adversary proceeding to subordinate the claims of the petitioners to the claims of all other general unsecured creditors. Federal Rule of Bankrupcy Procedure 7001(8).

Under applicable Delaware law, the petitioners were always creditors of the debtor. The debtor "readily acknowledges that there was no wrongful or fraudulent conduct on the part of the" petitioners (App., *infra*, 37a). The petitioners never held any equity interest in the debtor. The debt due to the petitioners was recorded and reported on the debtor's financial records from the time of the debtor's inception as a "newly formed corporation" (App., *infra*, 2a).

The creditor claim of the petitioners arises from a leveraged buy-out orchestrated by the debtor's parent corporation in 1989, over three years before the debtor's bankruptcy case. Before 1989, the petitioners, themselves or their predecessors in interest, owned shares in a manufacturing company then known as Envirodyne Industries, Inc., whose stock was publicly-traded. With funding provided by a group of banks ($316 million) and the sale of notes ($450 million), the debtor's parent made an offer to purchase all outstanding shares of the common stock of the manufacturing company for $40/share. The petitioners failed to tender their shares and have never received any payment.

Having acquired 98% of the outstanding shares, the parent merged the manufacturing company with another corporation that it formed to make the tender offer. On June 1, 1989, the merger was declared in accordance with the Delaware short-form merger statute. The newly formed corporation changed its name to Envirodyne Industries, Inc. The shares of the former company held by the petitioners were automatically canceled. The petitioners then "ceased to be equity holders and became creditors of [the newly formed corporation], entitled to receive $40 per share, without interest, upon demand (App., *infra*, 32a). They were "cashed-out" (App., *infra*, 2a).

In the bankruptcy case, the debtor scheduled the claims of the petitioners and the other "cashed-out," unpaid parties as

fixed and liquidated and in the total amount of $2,175,000. The petitioners had the status of general unsecured creditors. But under the debtor's plan of reorganization, the petitioners' claims were to be subordinated to those of all other general unsecured creditors, who were to receive stock in the reorganized debtor. Since the bankruptcy estate is insufficient to pay the other general secured creditors in full, the petitioners receive no distribution. The banks that financed the leveraged buy-out, however, received full payment in cash, and the noteholders who also financed the buy-out received either new notes equaling the full amount due to them or stock in the reorganized debtor.

The bankruptcy court allowed the subordination, holding that the petitioners, "although legally creditors," "are not entitled to the same distribution as an ordinary creditor in a plan of reorganization" (App., *infra*, 50a). It recognized that the "underlying theme of the Bankruptcy Code is equality of distribution" among creditors with equal priority (App., *infra*, 43a). It recognized that the petitioners had not engaged in any inequitable conduct, so that if misconduct was a necessary prerequisite for equitable subordination, then the petitioners would be entitled to a judgment dismissing the subordination action (App., *infra*, 37a). It recognized that on the issue of the necessity for misconduct, the legislative history of § 510(c) was ambivalent; "the legislative history pendulum swings both ways" (App., *infra*, 39a). But relying upon the Seventh Circuit's decision in *In re Virtual Network Services Corp.*, 902 F.2d 1246 (7th Cir. 1990), it concluded that the doctrine of equitable subordination no longer "focuses" upon conduct of the creditor, but upon fairness to other creditors (App., *infra*, 50a). Adopting the arguments of the debtor, it then ruled that subordination was appropriate "solely because of the origin of the claim" (App., *infra*, 37a). Since the petitioners' claims had their historical antecedents in their equity interest in the corporation acquired by the debtor's parent years before the bankruptcy and before

formation of the debtor, they were to be treated as an equity interest in bankruptcy. That Delaware law changed the status of the petitioners from equity holders to creditors was found to be "of no consequence" (App., *infra*, 51a).

The district court affirmed the suhordination. It too recognized that the petitioners "did not engage in any wrongful or fraudulent conduct" (App., *infra*, 16a). It too recognized that discerning the congressional intent in § 510(c) from its legislative history was unsatisfactory because the "legislative history of the section is decidedly mixed" (*ibid.*). Nonetheless, it found that Congress intended that courts may subordinate claims "because of the status or nature of the claim" (App., *infra*, 17a). It too relied upon *In re Virtual Network Services, Inc., supra,* for the proposition that "[c]reditor misconduct is not a prerequisite to equitable subordination in the Seventh Circuit" (*ibid.*). Focusing on fairness to other creditors (App., *infra*, 18a), it agreed with the bankruptcy court that the claims of the petitioners should be subordinated "[g]iven the nature of the claims" (App., *infra*, 22a). It ruled that the bankruptcy court's power of equitable subordination even allows it to preempt any state law that would accord to a party a valid claim against a bankruptcy estate (App., *infra*, 26a).

The court of appeals affirmed on March 15, 1996. It explained that equitable subordination is based upon a "fluid concept of equity" (App., *infra*, 5a), and that the "broad power" to subordinate naturally affords a discretion to consider unsecured claims so as to achieve "a fair distribution of the estate among all creditors" (App., *infra*, 9a). It reiterated that inequitable conduct was not necessary for subordination (App., *infra*, 4a) and that a court may "look to the origin and nature of the unsecured claim and decide whether equity requires that it be subordinated to claims of other general unsecured creditors" (App., *infra*, 6a). It concluded that since the petitioners' claims

were "based on equity interests" in a corporation purchased by the debtor's parent, then "their equity interest were legally subordinated to possible claims of unsecured creditors" of the debtor (App., *infra*, 7a-8a).

REASONS FOR GRANTING THE WRIT

The Supreme Court has granted certiorari this term in two cases that raise the issue whether principles of equitable subordination allow a bankruptcy court to subordinate the government's claims in the absence of any misconduct by the government; the government's claims in one case involved a post-petition non-pecuniary loss penalty for non-payment of taxes, and in the other case for a tax on a pension plan funding deficiency. *United States v. Noland,* No. 95-323, and *United States v. Reorganized CF&I Fabricators of Utah, Inc.*, No. 95-325. In his petition for certiorari in the first case, the Solicitor General correctly pointed out that "the court of appeals has seriously misapplied the judge-made doctrine of 'equitable subordination' and unloosened that doctrine from its proper moorings." Petition for Certiorari at 9, *United States v. Noland,* No. 95-323. This case demonstrates how far adrift courts have now taken the doctrine. Having untied the doctrine from the requirement of inequitable conduct, courts now feel free to subordinate claims of innocent parties resulting from arms length transactions years before the bankruptcy, regardless of provisions of state law or the Bankruptcy Code and based solely on a court's unfettered notions of fairness.

Certiorari should be granted in this case for three reasons: to resolve the issue concerning the requirement of inequitable conduct left open by the Supreme Court's recent decision in *United States v. Noland*; to restore uniformity in the application of the doctrine of equitable subordination among the circuits; and to regain certainty and predictability in the law for common

citizens and public investors by eliminating the unbridled discretion of a court to make ad hoc determinations about valid claims based solely upon an individual judge's notions of the fairness of a particular result.

I.

On May 13, 1996, the Supreme Court decided *United States v. Noland*, reversing the subordination of the government's tax penalty claim. The Court held that "the bankruptcy court may not equitably subordinate claims on a categorical basis in derogation of Congress's scheme of priorities." 56 S. Ct. Bull. (CCH) B1582. It concluded that the lower courts' subordination of a tax penalty claim was based solely upon the nature of the claim, which "was a categorical distinction at a legislative level of generality." *Id.* at B1587. But the Court did not decide "whether a bankruptcy court must always find creditor misconduct before a claim may be equitably subordinated." *Id.* at B1589. That is the very issue in this case. The bankruptcy court below stated that if inequitable conduct was necessary for subordination, then the petitioners would have been entitled to judgment because they committed no misconduct (App., *infra*, at 37a).

While the two cases before the Supreme Court this term involved vindication of congressional judgments as set forth in the priorities provision of the Bankruptcy Code (11 U.S.C. § 507), this case involves neither tax claims nor any other priority claim; the petitioners sought to be treated as general unsecured creditors. So long as equitable subordination remains adrift from its mooring of inequitable conduct, courts, as those below, will continue to feel free to effectively reject the claims of innocent creditors with claims valid under state law because the court disapproves of the claim or of the claimants or because the court seeks a certain result.

II.

The second reason why certiorari should be granted is to restore uniformity in federal bankruptcy law by resolving conflicts among the circuit courts of appeals and among trial courts concerning whether inequitable conduct is a prerequisite to the exercise of the power to subordinate the non-priority, general unsecured claims of creditors. In *United States v. Noland,* the Supreme Court recognized the conflict between the courts of appeals: "[i]n keeping with the pre-1978 doctrine, many Courts of Appeals have continued to require inequitable conduct before allowing the equitable subordination of most claims, although several have done away with the requirement when the claim in question was a tax penalty." *Id.* at B1585-86 (citations omitted). So too the bankruptcy court below (App., *infra*, 36a) acknowledged that the "vast majority of courts" require inequitable conduct before subordinating, following the three-part test formulated by the Fifth Circuit in *Benjamin v. Diamond (In re Mobile Steel Co.),* 563 F.2d 692 (5th Cir. 1977).

But as this case demonstrates, relying on *In re Virtual Network Services, supra,* and its progeny, courts have not only done away with inequitable conduct in tax penalty cases, but also now feel no constraint on their equitable power to subordinate whenever the court seeks to structure a desired result. App., *infra*, 5a; *see also, In re New Era Packaging, Inc.*, 186 B.R. 329 (Bankr. D. Mass. 1995), a case involving the subordination on a claim based upon a stock redemption agreement, where the court noted the unfairness of its decision to the claimants (*id.* at 336), but nonetheless equitably subordinated the claim "as a matter of law" (*id.* at 337), and *In re SPM Manufacturing Corp.*, 163 B.R. 411 (Bankr. D. Mass. 1994), a case involving the subordination of the claim of a charitable trust in a stock repurchase transaction valid under state law, where the court concluded that its power to equitably subordinate even preempts state laws that "promote

certainty in the enforcement of a contract reflecting a significant business transaction." *Id.* at 420-21.

In the absence of uniformity, valid claims of innocent citizens and investors, created by state corporations law, are being rejected in some circuits, but enforced in others, depending upon the happenstance of venue. As this case demonstrates, in the Seventh Circuit a claim valid under state corporations law can be subordinated in the absence of misconduct. Yet in another circuit, the rule is that "if the transaction on which the claim is based is not invalid under state law, and no fraud is involved, the claim should not be subordinated pursuant to § 510(c)." *In re Stern-Slegman-Prins Co.*, 86 B.R. 994, 1000 (Bankr. W.D. Mo. 1988), a stock repurchase case in which the court examined the same cases relied upon by the courts below in this case (App., *infra*, at 7a, 20a, 42a) and concluded that those cases were no longer good law (*id.* at 998).

Subordination of the claims of innocent parties with valid claims under state law ignores the directive of the Supreme Court that there should be uniformity in treatment of property rights accorded by state law so as to prevent "windfalls by reason of the happenstance of bankruptcy." *Butner v. United States*, 440 U.S. 48, 55, 99 S. Ct. 914, 918, 59 L. Ed. 2d 136 (1961).

The absence of uniformity also violates a predominant policy objective of a bankruptcy proceeding, "equal treatment of similarly situated creditors." *In re PCH Associates*, 949 F.2d 585, 598 (2d Cir. 1991). The Supreme Court has indicated that the equitable power of a bankruptcy court is circumscribed: "whatever equitable power remains in the bankruptcy court must and can only be exercised within the confines of the Bankruptcy Code." *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206, 108 S. Ct. 963, 968, 99 L. Ed. 2d 169 (1988). But no-fault

subordination allows a bankruptcy court, as in this case, to "use its equitable power to achieve a result not contemplated by the code," *i.e.*, unequal treatment of creditors with valid claims under state law, rather than "to fulfill some specific code provision." *Murgillo v. California State Board of Equalization (In re Murgillo)*, 176 B.R. 524, 531 (Bankr. 9th Cir. 1995).

Uniformity would avoid the anomaly that has occurred in this case. The petitioners are denied any distribution on their claim for payment for the proprietary interest taken from them in the leveraged buy-out. They are denied any payment upon the sole basis that their claims originated in an equity interest, albeit not in the debtor, but in a corporation purchased by the debtor's parent years before the bankruptcy. The debt to the petitioners was incurred to purchase equity, in the view of the courts below. Likewise in this case, the banks' debt was also incurred to purchase equity, *i.e.*, the petitioners' equity interest in a functioning corporation. Yet the banks that financed the leveraged buy-out are not subordinated, but are paid in full, in cash, in the bankruptcy distribution. For the banks, inequitable conduct is necessary for subordination. As another judge in the same bankruptcy court as below held in another case, "there is nothing in the nature of the financing of a leveraged buyout that creates any grounds for subordination without inequitable conduct." *In re Telesphere Communications, Inc.*, 179 B.R. 544, 561-62 (Bankr. N.D. Ill. 1994).

III.

The third reason that certiorari should be granted is to restore certainty and predictability upon which ordinary citizens and public investors may depend in structuring their transactions and so that they can be forewarned about what actions will result in subordination. "At the heart of the Bankruptcy Code lies the importance of predicting the order of claims when a company

becomes bankrupt. . . ." Scott M. Browning, *No Fault Equitable Subordination: Reassuring Investors That Only Government Penalty Claims Are At Risk*, 34 Wm. & Mary L.Rev. 487, 489 (1993). Certainty and predictability are lost, with tragic consequences to ordinary citizens and investors, when as in the so-called "no-fault" subordination, courts take unto themselves an undefined discretion to redistribute property rights in accordance with personal views of justice or fairness. Certainty and predictability are enhanced when a court abides by the principle that "it is not free to adjust the legally valid claim of an innocent party who asserts the claim in good faith merely because the court perceives that the result is inequitable." *Matter of Chicago, Milwaukee, St. Paul & Pacific Railroad Co.*, 791 F.2d 524, 528 (7th Cir. 1986). As one commentator has expressed, "[t]he courts that have chosen to expand their equitable powers deserve no commendation for their cavalier willingness to throw the doctrine of equitable subordination back to the unformulated principles of fairness; rather they should be criticized for endangering the security of creditors." Browning, *supra*, at 518.

Accordingly, returning the doctrine of equitable subordination to its mooring of inequitable conduct upholds the Bankruptcy Code's overarching principle of equality of distribution of similarly situated creditors, ensures uniformity in application of the doctrine throughout the federal courts, promotes comity between the federal and state laws regarding property rights, and forewarns the citizen and public investor as to what actions will lead to subordination.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be granted.

Dated: June 12, 1996

Respectfully submitted,

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APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT DATED MARCH 15, 1996

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

Nos. 95-2733, 952734, 95-2735, and 95-2754

IN THE MATTER OF: ENVIRODYNE INDUSTRIES, INC.,

Debtor-Appellee.

APPEALS OF:

SEYMOUR J. RYCKMAN, ILLINOIS DEPARTMENT OF FINANCIAL INSTITUTIONS, STATE OF CALIFORNIA, JERRY M. FRIEDMAN, as custodian for Julie, Jennifer and Mark Friedman, JAMES NULL, and DAVID B. BLOOM.

Appeals from the United States District Court
for the Northern District of Illinois, Eastern Division.
Nos. 95 C 1624, 95 C 1625, and 95 C 1723 —
Suzanne B. Conlon, *Judge*.

ARGUED JANUARY 16, 1996 — DECIDED MARCH 15, 1996

Before CUMMINGS, RIPPLE and EVANS, *Circuit Judges*.

CUMMINGS, *Circuit Judge*. Defendants in this case failed to tender shares of stock in a corporation entering a short form merger under Delaware law. Their equity interest was thus converted into debt and they retained the right to redeem their

canceled shares for a specified amount without interest. They failed to do so, however, before the newly formed corporation filed for Chapter 11 bankruptcy, and Defendants now complain that the Bankruptcy Court improperly subordinated their claims to those of other general unsecured creditors. We affirm the decision to subordinate Defendants' claims under 11 U.S.C. § 510(c).

In 1989, organizers formed Emerald Acquisition Corporation ("Emerald") and Emerald Sub One, Inc. ("Emerald Sub"), a wholly owned subsidiary of Emerald, for the purpose of acquiring Envirodyne Industries, Inc. ("Former Envirodyne"). Emerald Sub was organized specifically to purchase the outstanding shares of common stock of Former Envirodyne. These entities entered into a merger agreement whereby Emerald Sub purchased tendered shares of Former Envirodyne at $40 per share. Emerald Sub purchased 13,104,980 shares tendered and not withdrawn out of approximately 18,382,324 shares issued and outstanding. On June 1, 1989, Emerald Sub and Former Envirodyne were merged under Delaware General Corporation Law, section 253, with current Envirodyne as the surviving entity.

Shareholders had a right to redeem their stock at $40 per share or dissent from the merger and obtain an appraisal under Delaware law. As of the effective date of the merger, however, Former Envirodyne's stock was canceled, and non-tendering shareholders ceased to be equity holders and instead became creditors of current Envirodyne. In essence, non-tendering shareholders were "cashed-out." The merger agreement provided that these cashed-out shareholders were entitled to receive $40 per share of Former Envirodyne stock upon demand, but without interest. Each of the Defendants before this Court is

a non-tendering stockholder of Former Envirodyne or a representative or successor in interest thereof. It is unclear from the record why Defendants failed to redeem their non-interest-bearing shares of Former Envirodyne for over three years after the merger.

On January 7, 1993, Envirodyne fled voluntary petitions for Chapter 11 bankruptcy. Its balance sheet reflected liabilities of $2,175,520 due to non-tendering, cashed-out shareholders of Former Envirodyne. Under the reorganization plan, general unsecured creditors received 32.28 shares of common stock in reorganized Envirodyne for each $500 of allowed claims (which was estimated to be approximately two-thirds of the allowed amount of their claims), and Envirodyne agreed to seek to subordinate the claims of non-tendering shareholders of Former Envirodyne. Pursuant to the plan and on September 23, 1993, Envirodyne commenced an adversary proceeding in Bankruptcy Court seeking equitable subordination of the non-tendering shareholders' claims to those of other general unsecured creditors. Subordination was granted by the Bankruptcy Court on cross-motions for summary judgment, *In re Envirodyne Indus., Inc.*, 176 B.R. 825 (Bankr. N.D. Ill. 1995), and the district court later affirmed. Thereafter, Envirodyne's stock declined in value and, as a result, the general unsecured creditors received distributions amounting only to about one-third of the allowed amount of their claims; the Defendants received no distribution.

The sole issue on appeal is whether the Bankruptcy Court properly subordinated Defendants' claims to those of other general unsecured creditors under Section 510(c) of the Bankruptcy Code, 11 U.S.C. § 510(c), without requiring proof of wrongful conduct on the part of Defendants. The Bankruptcy Code provides as follows:

> Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may —
>
> > (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or
> >
> > (2) order that any lien securing such a subordinated claim be transferred to the estate.

11 U.S.C. § 510(c). Exactly what "principles of equitable subordination" Congress had in mind is not clear from the Bankruptcy Code, but we have previously held based on the legislative history that Congress intended courts to develop the appropriate principles, which might be broader than the principles existing prior to Section 510(c)'s enactment. *In re Virtual Network Servs. Corp.*, 902 F.2d 1246, 1249-1250 (7th Cir. 1990); *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1356 (7th Cir. 1990). Defendants' primary contention is that, at a minimum, equitable subordination requires inequitable conduct on the part of the creditor. But *Virtual Network* has disposed of that issue as well:

> In sum, we conclude that § 510(c)(1) authorizes courts to equitably subordinate claims to other claims on a case-by-case basis without requiring in every instance

> inequitable conduct on the part of the creditor claiming parity among other unsecured general creditors.

902 F.2d at 1250; see also *In re Vitreous Steel Prods. Co.*, 911 F.2d 1223, 1237 (7th Cir. 1990) (the Section 510(c) inquiry is to be made on a case-by-case basis focusing on fairness to other creditors). Accord *In re CF&I Fabricators of Utah, Inc.*, 53 F.3d 1155 (10th Cir. 1995), certiorari granted, 116 S. Ct. 558 (Dec. 1, 1995); *In re First Truck Lines, Inc.*, 48 F.3d 210 (6th Cir. 1995), certiorari granted, 116 S. Ct. 558 (Dec. 1, 1995); *Burden v. United States*, 917 F.2d 115 (3d Cir. 1990); *Schultz Broadway Inn v. United States*, 912 F.2d 230 (8th Cir. 1990).

Defendants argue that *Virtual Network* carved out only a limited no-fault subordination rule for non-pecuniary loss claims, such as tax penalties and punitive damage awards. We find no language in the opinion limiting our review of congressional intent to non-pecuniary loss claims. Rather, we concluded in *Virtual Network* that Congress intended to give courts authority for developing principles of equitable subordination — principles that may or may not include a requirement of inequitable conduct. We ultimately held that inequitable conduct is not required for subordination of non-pecuniary loss tax penalty claims, but that limited holding takes nothing away from our general interpretation of Section 510(c). The flexible approach of *Virtual Network* makes sense in light of the Bankruptcy Code's primary goal of equality of distribution and the fluid concept of equity at the heart of Section 510(c) subordination.

In support of their argument, Defendants also rely on *In re Mansfield Tire & Rubber Co.*, 942 F.2d 1055 (6th Cir. 1991),

certiorari denied, 502 U.S. 1092, which found that *Virtual Network* was inapplicable to an excise tax payable to the government under 26 U.S.C. § 4971. The Sixth Circuit there stated that "whatever persuasive value [*Virtual Network* and its progeny] may have had for a case concerning nonpecuniary loss *penalties*, they are inapposite here." *Id.* at 1061 (emphasis in original). But *Mansfield* was premised on the fact that Section 507 of the Bankruptcy Code establishes the priority of an "excise tax," 11 U.S.C. § 507(a)(7)(E), precluding such taxes from being otherwise "susceptible to subordination" within the meaning of Section 510(c). 942 F.2d at 1062. As such *Mansfield* does not support Defendants' argument that *Virtual Network* carved out a limited no-fault exception. In fact, the Sixth Circuit has since confirmed our understanding of *Mansfield*, see *First Truck Lines*, 48 F.3d at 213, and further stated that Section 510(c) allows for no-fault equitable subordination under developing principles in the courts. *Id.* at 218.

We thus adopt the flexible approach of *Virtual Network* in which a court must look to the origin and nature of the unsecured claim and decide whether equity requires that it be subordinated to claims of other general unsecured creditors. In this regard, Defendants make their alternative argument: that the nature of their unsecured claims is such that the Bankruptcy Court should not have exercised its power (which we hold above that it has) to subordinate Defendants' claims to those of other unsecured creditors absent inequitable conduct. They analogize to cases dealing with debt arising from an asset purchase of an existing company by the debtor in which courts have required inequitable conduct for subordination. See, *e.g.*, *In re EDC, Inc.*, 930 F.2d 1275 (7th Cir. 1991). But the asset purchase cases are easily distinguished, both because the debtor in such cases receives assets in exchange for incurring debt, unlike Defendants here,

and because they involve subordination of secured claims to unsecured claims.

More persuasive are cases involving the claims of former shareholders in stock redemptions. In such cases, courts generally use equitable subordination to subordinate the claims of former shareholders who redeemed their stock to the issuing corporation in exchange for debt. See, *e.g.*, *Robinson v. Wangemann*, 75 F.2d 756 95th Cir. 1935). The former shareholders, considered creditors rather than equity holders, are in form equivalent to other general unsecured creditors. Nonetheless, courts look to the substance of the transaction. Because the stock redemption is a transaction by which a corporation acquires its own stock from stockholders, it is simply a method of distributing a proportion of the assets to stockholders. See *id.* at 757. In substance, the former stockholders become equity holders rather than creditors on par with the corporation's other creditors. Thus subordination of claims in bankruptcy is equitable: "The assets of a corporation are the common pledge of its creditors, and stockholders are not entitled to receive any part of them unless creditors are paid in full." *Id.*

Defendants are legally creditors of Envirodyne, no doubt, just as the former shareholders in *Robinson* were legally creditors of the corporation to which they redeemed their stock. But Defendants' claims are, in substance, based on equity interests. When they invested in Former Envirodyne, they positioned themselves to benefit if the company performed well but they also accepted the risk that the company might perform poorly. Thus Defendants accepted risks and benefits that Former Envirodyne's unsecured creditors did not, and as such their equity interests were legally subordinate to possible claims of

unsecured creditors. Their current status as creditors arose from their failure to tender shares in the Emerald Sub short-form merger under Delaware law, as well as their failure to redeem their non-interest-bearing shares of Former Envirodyne in the three years subsequent to the merger. No amount of maneuvering can obscure the true nature of Defendants' interest. We further agree with the district judge's analysis that subordination is even more compelling here than in a stock redemption case. In a stock redemption, the shareholders make a conscious decision to relinquish their equity for debt. In this case, however, Defendants became creditors because they failed to redeem their shares, and their dilatory behavior is inexplicable given that they merely held non-interest-bearing canceled shares of Former Envirodyne. Thus their claims in bankruptcy are far weaker than other general unsecured creditors.

Defendants' proffered distinction of the stock redemption cases places form over substance and is thus contrary to the very rationale of those cases. Defendants argue that any risk or benefit they accepted as shareholders of Former Envirodyne came to an end after the merger, taking away any equity interest they had; left only with debt of the company, they assumed no more risk after the merger than any other unsecured creditor. We are not persuaded. Defendants' argument ignores the crux of the stock redemption cases: that the proper focus is on the nature and origin of the claim. Their claims indisputably arose out of an equity interest in Former Envirodyne, and the essential nature of the claims did not change after the merger. As in a stock redemption, where the stockholder accepting debt as payment for the stock assumes the risk of future insolvency, Defendants assumed the risk of Envirodyne's insolvency when they failed to tender their shares during the merger or anytime thereafter. Though in both cases the claims are legally those of creditors,

they are in origin and nature claims based on equity interests. Nothing in the denomination "creditor" exempts a claimant from Section 510(c) equitable subordination.

Further, the fact that Delaware law converted Defendants' surviving interest into debt rather than equity does not change our analysis. The form of the transaction does not alter the origin and nature of Defendants' claims as essentially equity interests. We find no precedent for the proposition that where state law deems a claimant a creditor, a Bankruptcy Court may not subordinate his claims to those of other unsecured creditors under Section 510(c). That provision gives Bankruptcy Courts broad power to subordinate claims based on "principles of equitable subordination." Such power naturally affords discretion to consider the substance of unsecured claims in order to implement the primary bankruptcy goal of achieving a fair distribution of the estate among all creditors. In this case, Delaware law affected the form of Defendants' claims, not their substance. In any event, we do not see a conflict between federal and state law in this case: state law determined the validity of the claims and federal bankruptcy law determined their priority among other valid claims.

Finally, Defendants argue that even if inequitable conduct is not a prerequisite to subordination, harm to the other unsecured creditors absent subordination is. We need not reach the legal question involved because we reject Defendants' premise — that the bankruptcy result for the other unsecured creditors is the same regardless of whether the court subordinates Defendants' claims. They correctly note that all of Envirodyne's general unsecured creditors received 32.28 shares of common stock in reorganized Envirodyne, an amount which will not change regardless of the subordination issue. However,

Defendants ignore the fact that any distribution to them will affect the value of the shares and therefore the distribution to the other creditors. The effect on other unsecured creditors might be even more substantial in light of the unexpected decline in Envirodyne's stock since confirmation of the reorganization plan.

In conclusion, we hold that Section 510(c) of the Bankruptcy Code authorizes courts to subordinate the unsecured claims of non-tendering, cashed-out shareholders of a short-form merger under Delaware law to those of other general unsecured creditors, and we further hold that equitable subordination was appropriate on the facts of this case. We also deny Envirodyne's petition to strike portions of Defendants' reply brief to this Court.

AFFIRMED.

A true Copy:

Teste:

_____

Clerk of the United States Court of
Appeals for the Seventh Circuit

APPENDIX B — MEMORANDUM OPINION AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF ILLINOIS DATED JUNE 20, 1995

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

Nos. 95 C 1624
95 C 1625
95 C 1723
95 C 2070

Judge Suzanne B. Conlon

IN RE:

ENVIRODYNE INDUSTRIES, INC.,

MEMORANDUM OPINION AND ORDER

Appellant State of California appeals an opinion and order of the United States Bankruptcy Court for the Northern District of Illinois, granting summary judgment in an adversary proceeding to debtor Envirodyne Industries, Inc. ("debtor" or "Envirodyne"). Envirodyne is the surviving entity of a short-form merger. The bankruptcy judge equitably subordinated the claims of former shareholders of the corporation extinguished by the merger to the claims of Envirodyne's general unsecured creditors pursuant to section 510(c)(1) of the Bankruptcy Code. 11 U.S.C. § 510(c)(1). The State of California is joined in this appeal by Jerry M. Friedman, as custodian for Julie Friedman, Jennifer Friedman, and Mark Friedman; James A. Null; Seymour

Ryckman; David B. Bloom; and the Illinois Department of Financial Institutions (collectively "appellants"). All appellants have adopted the brief of the State of California. This court has jurisdiction pursuant to 28 U.S.C. § 158(a).

BACKGROUND

The facts are undisputed. In 1989, Emerald Acquisition Corporation ("Emerald") was formed for the purpose of acquiring Envirodyne Industries, Inc. (former Envirodyne). Emerald was organized by Salomon Brothers Holding Company Inc. and D.P. Kelly & Associates. Also in 1989, these organizers formed Emerald Sub One, Inc. ("Emerald Sub") as a wholly owned subsidiary of Emerald. Emerald Sub was organized to make an offer to purchase for cash all outstanding shares of former Envirodyne common stock. Emerald, Emerald Sub, and former Envirodyne entered into a merger agreement. Pursuant to the merger agreement, Emerald Sub purchased tendering shares of former Envirodyne at $40 per share. At the time of the tender offer, former Envirodyne had approximately 18,382,324 shares issued and outstanding. Emerald Sub purchased all 13,104,980 shares tendered and not withdrawn. Some shareholders of former Envirodyne did not respond to Emerald Sub's tender offer. On June 1, 1989, Emerald Sub and former Envirodyne were merged in accordance with Delaware's short-form merger statute, DGCL § 253, with current Envirodyne emerging as the surviving entity. Envirodyne assumed all liabilities and became a wholly owned subsidiary of Emerald.

The stock of former Envirodyne was cancelled as of the effective date of the merger. As of that date, any nontendering former Envirodyne shareholders ceased to be equity holders and instead became creditors of current Envirodyne. The merger agreement provided that these cashed-out shareholders were

entitled to receive $40 per share of former Envirodyne stock, without interest, upon demand. Merger Agreement § 2.02. Each of the appellants is a nontendering shareholder of former Envirodyne, a representative thereof, or a successor in interest thereof; the appellants became creditors of Envirodyne pursuant to the merger agreement and § 253 of Delaware General Corporation Law. Envirodyne unsuccessfully attempted to locate nontendering shareholders of former Envirodyne after the merger. Donvan Aff. 13. The record is silent as to why the appellants failed to redeem their non-interest bearing shares of former Envirodyne for over three years after the merger.

On January 7, 1993, Envirodyne filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code. Envirodyne's balance sheet reflected a liability of $2,175,520 due to the nontendering shareholders of former Envirodyne. Under Envirodyne's reorganization plan, general unsecured creditors received 32.28 shares of common stock in reorganized Envirodyne for each $500 amount of allowed claim. The plan also provided that Envirodyne would seek to have the claims of the cashed-out shareholders of former Envirodyne subordinated so that those shareholders would receive nothing; accordingly, the appellants did not receive a distribution.[1] Using this process, Envirodyne estimated that each general unsecured creditor would receive stock with a market value equal to approximately two-thirds of the allowed amount of its claims. On September 23, 1993, pursuant to the plan, Envirodyne commenced an adversary proceeding in the bankruptcy court seeking to equitably subordinate the claims of nontendering shareholders of former Envirodyne to the claims held by Envirodyne's other general

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1. If Envirodyne failed to subordinate the claims of the cashed-out former shareholders, those claims were to be treated equally to those of any other general unsecured creditor.

unsecured creditors pursuant to § 510(c) of the Bankruptcy Code.

The parties filed cross-motions for summary judgment. The bankruptcy court first determined that Envirodyne could equitably subordinate the claims of the former shareholders without showing that the shareholders had engaged in any wrongdoing. The bankruptcy judge then held that the nature of the former shareholders' claims (*i.e.*, the nature of their creditor status *vis-a-vis* the nature of the other general unsecured creditors' claims) justified equitable subordination of their claims to protect the claims of the other general unsecured creditors. As a result, the court determined that the appellants would not receive a distribution unless the assets in the bankrupt's estate were sufficient to pay fully the other general unsecured creditors.

Envirodyne's stock unexpectedly declined in value after confirmation of the plan. Envirodyne's general unsecured creditors received distributions amounting only to about one-third of the allowed amount of their claims. Thus, the general unsecured creditors have not been paid in full, and the appellants have not received a distribution.

DISCUSSION

The bankruptcy court equitably subordinated the claims at issue by granting Envirodyne's summary judgment motion in the adversary proceeding. Because the bankruptcy court's decision rests on conclusions of law and statutory interpretation, this court's standard of review is *de novo*. *See Matter of Seibert*, 914 F.2d 102, 105-05 (7th Cir. 1990).

Appendix B

A. Applicable Standard for Equitable Subordination

The bankruptcy court equitably subordinated claims of nontendering shareholders of a short-form merger executed pursuant to Delaware law. The bankruptcy court's power to equitably subordinate claims is codified in § 510(c) of the Bankruptcy Code. Section 510(c) provides:

> Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may —
>
> (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or
>
> (2) order that any lien securing such a subordinated claim be transferred to the estate.

11 U.S.C. § 510(c).

The shareholders contend that "principles of equitable subordination" necessarily require that a subordinated claimant have engaged in some inequitable conduct. As the bankruptcy court recognized, many courts refuse to equitably subordinate a creditor's claim without a showing of misconduct on the part of the creditor. *See In re Envirodyne Indust. Inc.*, 176 B.R. 825, 829 (Bankr. N.D. Ill. 1995); *see also Benjamin v. Diamond (In re Mobile Steel Co.*, 563 F.2d 692, 700 (5th Cir. 1977); *In re*

Fabricators Inc., 926 F.2d 1458, 1464 (5th Cir. 1991); *In re Mansfield Tire & Rubber Co.*, 942 F.2d 1055, 1061 (6th Cir. 1991). The parties agree that the appellants did not engage in any wrongful or fraudulent conduct.

The appellants argue that the bankruptcy court erred by equitably subordinating their claims without a showing of fraudulent or wrongful conduct. This court disagrees. Section 510(c) permits the bankruptcy court to subordinate claims "under principles of equitable subordination." The Bankruptcy Code does not define this phrase. Legislative history must be considered to discern the intent of Congress. The legislative history of the section is decidedly mixed. *See generally In re Virtual Network Servs.*, 98 B.R. 343 (N.D. Ill. 1989) (engaging in a comprehensive review of section 510(c)'s legislative history). Section 510(c)(1) represents a compromise between different language used in House and Senate versions of the bill. *See* S. Rep. No. 989, 95th Cong., 2d Sess. 74 (1978), *reprinted in* 1978 U.S. Code & Cong. Admin. News 5787, 5860. The Seventh Circuit has determined that the most reliable reflections of congressional intent are the nearly identical statements of Representative Edwards and Senator DiConcini, the respective sponsor and co-sponsor of the House and Senate bills, who met to reconcile the differences. *See In re Virtual Network Servs.*, 902 F.2d 1246, 1249-50 (7th Cir. 1990). Representative Edwards stated:

> It is intended that the term "principles of equitable subordination" follow existing case law and leave to the courts the development of this principle. To date, under existing law, a claim is generally subordinated only if [the] holder of such

> claim is guilty of inequitable conduct, or the claim itself is of a status susceptible to subordination, such as a penalty. . . .

124 Cong. Rec. H11,089-H11,117 (daily ed. Sept. 28, 1978), *reprinted in*, 1978 U.S. Code & Cong. Admin. News 5787, 6452. This statement expressly suggests that courts may subordinate claims both because of creditor misconduct and because of the status or nature of the claim.

In light of this language, it appears that Congress intended courts to develop the "principles of equitable subordination." *See In re Virtual Network Servs.*, 902 F.2d at 1249-50. The Seventh Circuit has found it "clear that in principle, equitable subordination no longer requires, in all circumstances, some inequitable conduct on the part of the creditor." *Id.* at 1250. Instead, "§ 510(c)(1) authorizes courts to equitably subordinate claims to other claims on a case-by-case basis without requiring in every instance inequitable conduct on the part of the creditor claiming parity among other unsecured general creditors." *Id.* Creditor misconduct is not a prerequisite to equitable subordination in the Seventh Circuit. Several other circuits have followed the Seventh Circuit's lead, and there now appears to be a growing consensus that creditor misconduct is not a prerequisite to equitable subordination. *See, e.g., United States v. Reorganized CF & I Fabricators, Inc.*, 1995 WL 246341 (10th Cir. Apr. 27, 1995); *In re First Truck Lines, Inc.*, 48 F.3d 210 (6th Cir. 1995); *In re Vitreous Steel Prods.*, 911 F.2d 1233, 1237 (7th Cir. 1990); *Schultz Broadway Inn v. United States*, 912 F.2d 230, 233 (8th Cir. 1990); *In re Burden*, 917 F.2d 115, 116-17 (3d Cir. 1990).

Although *Virtual Network* establishes the Seventh Circuit

rule that creditor misconduct is not a prerequisite to equitable subordination, the appellants inexplicably fail to discuss the case or even cite to it. The appellants do, however, attempt to address the issue indirectly in two ways. First, the appellants note that several recent bankruptcy decisions in the Seventh Circuit have required a showing of misconduct before subordinating a claim. *See In re Octagon Roofing*, 141 B.R. 968 (Bankr. N.D. Ill. 1992); *In re Aluminum Mills Corp.*, 132 B.R. 869 (Bankr. N.D. Ill. 1991).[2] However, these cases acknowledge Virtual Network and expressly limit application of a misconduct requirement to situations where a debtor is attempting to subordinate a secured claim to an unsecured claim. It appears that the Seventh Circuit retains a misconduct requirement in such a situation. *See Kham & Nate's Shoes No. 2 v. First Bank*, 908 F.2d 1351 (7th Cir. 1990). Second, the shareholders contend that cases that dispense with the misconduct requirement are limited to the facts before them, such as treatment of tax penalties and punitive damage awards. The court disagrees. The Virtual Network holding represents a fundamental interpretation of the equitable subordination provision. The court broadly held that § 510(c)(1) "authorizes courts to equitably subordinate claims . . . on a case-by-case basis without requiring in every instance inequitable conduct on the part of the creditor." *In re Virtual Network*, 902 F.2d at 1250. This case-by-case inquiry should be made by "focusing on fairness to the other creditors" and by considering "all the circumstances," which may include the status or nature of a claim. *In re Vitreous Steel Prods.*, 911 F.2d at 1237.

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2. The shareholders also cite *In re Chapman*, 146 B.R. 411 (Bankr. N.D. Ill. 1992), as requiring a showing of misconduct prior to subordination. However, *Chapman* actually applied the *Virtual Network* standard, but concluded that fairness did not require subordination of the claims in that case. *See In re Chapman*, 146 B.R. at 418-19.

Appendix B

B. Subordination of the Appellants' Claims

Under the above analysis, Envirodyne may be entitled to equitably subordinate the claims of the nontendering shareholders without proving that those shareholders engaged in wrongful or fraudulent conduct. Proceeding under this reasoning, the bankruptcy court examined the nature and origins of the appellants' claims against the estate, and concluded that the appellants' claims should be subordinated to the claims of the debtor's other general unsccured creditors. The court agrees with this disposition.

Among other aims, the Bankruptcy Code is designed to promote equality of distribution and fairness to creditors in the treatment of their claims. *See, e.g., Begier v. I.R.S.*, 496 U.S. 53 (1990); *Local Loan Co. v. Hunt*, 292 U.S. 234 (1934). As a court of equity, the bankruptcy court is entrusted with the responsibility to produce results "to the end that fraud will not prevail, that substance will not give way to form, [and] that technical considerations will not prevent substantial justice from being done." *Pepper v. Litton*, 308 U.S. 295, 305 (1939). Equitable subordination plays an important role in this process. The fundamental aim of equitable subordination is to "undo or offset any inequity in the claim position of a creditor that will produce injustice or unfairness to other creditors in terms of the bankruptcy results." *In re Virtual Network*, 98 B.R. at 350 (quoting *In re Kansas City Journal-Post Co.*, 144 F.2d 791, 800 (8th Cir. 1944)). The doctrine may not be used to punish a creditor who has acted inequitably. Instead, equitable subordination may be employed "only to adjust the claims of creditors as they stand in equitable relation to each other." *In re Virtual Network Servs.*, 98 B.R. at 351; *In re Mobile Steel Corp.*, 563 F.2d at 699-700. Thus, the doctrine concerns the nature of the

distribution of the estate, not the conduct of the creditor whose claim is to be subordinated; courts must apply the doctrine only to effect a fair distribution of the bankrupt's estate among creditors. *In re Virtual Network Servs.*, 98 B.R. at 351.

The bankruptcy court determined that a fair distribution of the debtor's estate among its creditors required subordination of the appellants' claims to the claims of the general unsecured creditors. In doing so, the bankruptcy court analogized the appellants' claims to the claims of former shareholders in stock redemption cases. Courts have long used concepts of equitable subordination to subordinate the claims of former shareholders who redeemed their stock to the issuing corporation and received debt in return. *See Robinson v. Wangemann*, 75 F.2d 756, 757 (5th Cir. 1935); *Liebowitz v. Columbia Packing Co.*, 56 B.R. 222 (D. Mass. 1985), *aff'd*, 802 F.2d 439 (1st Cir. 1986); *Weisman v. Goss (Matter of Hawaii Corp.)*, 694 F.2d 179 (9th Cir. 1982); *McConnell v. Butler*, 402 F.2d 362 (9th Cir. 1968). In these cases, a shareholder generally redeemed his stock to the issuing corporation and received some form of debt in its stead. Before making payment on the debt, however, the issuing corporation became insolvent. Thus, the former shareholder, whose claim was considered to be debt and not equity on the corporate books, joined other unsecured creditors in making claims against the bankrupt's estate.

In subordinating the claims of the former shareholders in stock redemption cases, courts focus on the true nature of the transaction. Because a corporation that purchases its own stock does not receive anything of value for the purchase equivalent to the depletion of its assets, stock redemptions are "simply a method of distributing a proportion of the [corporation's] assets to the stockholder." *Robinson*, 75 F.2d at 757. And because the

assets of a corporation are the common pledge of its creditors, the former shareholders are not entitled to any part of the assets unless the creditors are fully paid. *Id.* This is true regardless of the good faith of the parties and notwithstanding the fact that the corporation was solvent at the time it issued the debt. The former shareholder who sells his stock to a corporation in return for a promissory note does not become a debt creditor who stands on equal footing with general creditors if the corporation becomes bankrupt; the underlying nature of the transaction survives, and the note remains an equity obligation. *Liebowitz*, 56 B.R. at 224; *Matter of Hawaii Corp.*, 694 F.2d at 181. Generally, former shareholders, even those holding debt instruments as a result of a stock redemption, are not entitled to a distribution of assets from an insolvent corporation in return for their stock until all of the corporation's creditors have been fully paid.

These principles are illustrated by *In re SPM Mfg. Corp.*, 163 B.R. 411 (Bankr. D. Mass. 1994), cited by the bankruptcy court. There, a shareholder sold several thousand shares of stock back to the debtor in exchange for a promissory note bearing interest at 12 percent per year. The debtor filed for bankruptcy before making payment on the note, and the unsecured creditors' committee sought to subordinate the former shareholders' claims to those of general unsecured creditors. The bankruptcy court agreed. First, the court determined that § 510(c) did not require a showing of misconduct on the part of the creditor. Instead, the court concluded that Congress empowered courts to equitably subordinate claims "because of their nature or origin." *In re SPM*, 163 B.R. at 414. The court then examined the nature and origin of the former shareholders' claims against the estate. Agreeing that stock redemption is in essence a dividend to the shareholder, the court determined that the stock redemption debt should be subordinated to the claims of general unsecured

creditors in bankruptcy because of the priority creditors in bankruptcy enjoy over shareholders. *See id.* at 414.

The bankruptcy court correctly subordinated the appellants' claims by applying these principles. Although the appellants are legally creditors of Envirodyne, their creditor status was created by their failure to timely tender their shares of former Envirodyne after the merger. Thus, unlike the debtor's general unsecured creditors, the appellants' claims against the estate arose as a result of an equity interest, an equity interest they did not pursue for over three years.[3] Given the nature of the claims, the appellants' claims should be subordinated to those of general unsecured creditors. As the bankruptcy court explained, the appellants invested in former Envirodyne

> without any guarantees that they would recover their investment. They invested in Former Envirodyne with the hope of sharing in its future earnings but with the risk that they may lose their investment in the event that the company fails or performs poorly. Contrast this with the position of a general unsecured creditor. When a supplier extends credit, it does so with the reasonable expectation that it will be repaid in due course for the goods or services that it provided. Conversely, regardless of how the company performs, it does not expect to

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3. If the appellants had demanded payment for their shares of former Envirodyne before Envirodyne became insolvent, Envirodyne would have paid $40 per share and the transaction would have been valid against all creditors. *See McConnell*, 402 F.2d at 366.

> share in any profits. Acreditor does not subject itself to the risks of a shareholder.

In re Envirodyne, 176 B.R. at 834.

Importantly, the appellants do not challenge the holdings or reasoning of the stock redemption cases on which the bankruptcy court relied. Instead, the appellants attempt to distinguish those cases in several ways. First, the shareholders contend that the stock redemption cases all involve two-party transactions in which a shareholder sold stock directly to the issuing corporation in exchange for debt. In contrast, the transaction in this case was not a stock repurchase by the issuing corporation, but was instead a tender offer made by a third-party seeking to acquire the issuing corporation; the shareholders became creditors by virtue of the Delaware short-form merger statute and the merger agreement.

Although the distinction urged by the appellants is noted, the appellants do not explain why that distinction alters the analysis. The holdings of both the stock redemption cases and the bankruptcy court below are grounded in the fact that the nature and origin of the claims at issue arose from equity interests. A stock redemption is a method of distributing a portion of the corporation's assets to the stockholder. When a stockholder sells stock to a corporation and receives a promissory note in return, the note remains an equity obligation; distribution of the assets is in effect delayed. If the corporation goes into bankruptcy, the general unsecured creditors are appropriately entitled to priority before the corporation makes good on its equity obligation. A stockholder who accepts debt as payment for his stock assumes the risk that the corporation will be solvent when the note becomes due. *Liebowitz*, 56 B.R. at 224.

The same reasoning applies to the appellants' claims. The appellants are shareholders of former Envirodyne who, for unexplained reasons, failed to tender their shares or dissent during the merger or for years thereafter. Because the entity former Envirodyne did not survive the merger, the merger agreement entitled nontendering shareholders to $40 per share if and when they decided to redeem. The stock of former Envirodyne was then cancelled and current Envirodyne, the surviving corporation, assumed all of the liabilities of former Envirodyne and Emerald Sub. Essentially, then, the appellants were forced into creditor status because of their failure to tender their shares in a timely fashion or to dissent from the merger. But however one characterizes it, the payment the appellants now seek is familiar: a distribution that springs from a former equity interest. As such, the court can discern no substantive difference between the nature of a stock redemption claim and the nature of the appellants' claims in this case. Thus, the court finds the appellants' distinction insignificant.

Indeed, it appears that subordination is more compelling in this situation than in the stock redemption cases. In stock redemption cases, the shareholder at least makes an affirmative decision to relinquish his equity interest for debt. In doing so, the shareholder may wish to escape the risks of equity. In this case, on the other hand, the appellants lost their equity interest and became creditors because they failed to redeem their shares of former Envirodyne in a timely fashion. It appears the appellants did not make a conscious choice to escape the risks by changing their equity into debt. Instead, they simply held onto their non-interest bearing cancelled shares of former Envirodyne. By delaying, the appellants assumed the risk that Envirodyne would be solvent when they sought payment. It would be inequitable to afford the appellants a priority equal to that of general creditors because they were dilatory in redeeming their equity interests.

Appendix B

The appellants also contend that the stock redemption cases are inapposite because unlike the shareholders in those cases, the appellants were never shareholders of post-merger Envirodyne (the debtor). However, the fact that the appellants held former Envirodyne stock instead of shares of the surviving entity does not elevate the appellants' claims to a status equal to that of the general unsecured creditors of the surviving corporate entity. *Matter of Hawaii Corp.*, 694 F.2d at 181 (equitably subordinating claims of former shareholders of non-surviving corporation to claims of general creditors of the post-merger surviving corporate entity). The appellants are creditors of current Envirodyne and seek a distribution from current Envirodyne. Given the nature of the appellants' claims, the bankruptcy judge did not err by analogizing those claims to stock redemption claims.

The appellants also attempt to distinguish the stock redemption cases by asserting that they were made creditors by operation of Delaware corporate law. In contrast, the stock redemption cases involve former shareholders who became creditors of the issuing corporation by entering into voluntary contractual arrangements. Thus, the appellants appear to argue that their claims are guaranteed priority equal to that of general unsecured creditors because the appellants became creditors automatically by operation of state statute as opposed to voluntary contractual arrangement.

The appellants' objection is misplaced. Envirodyne does not contend that the appellants' claims are unenforceable. Moreover, contrary to the appellants contention, Envirodyne does not seek to treat the appellants' claims as equity. Instead, Envirodyne concedes that the appellants are general unsecured creditors and have enforceable claims as unsecured creditors

under Delaware law. *See* Envirodyne Br. at 22. But having a valid claim under state law, even if created by state law, does not mean that a creditor must necessarily be treated equally with other general unsecured creditors under federal bankruptcy law. The Bankruptcy Code expressly permits courts to apply "principles of equitable subordination" to subordinate certain claims in order to effect a just and fair distribution of the bankrupt's estate; subordination is permitted either because of misconduct or because of the nature or status of a particular claim. The appellants' claims were subordinated pursuant to this provision, vindicating bankruptcy policy of compensating creditors before equity interests. If a state law conflicts with the Bankruptcy Code's provision for equitable subordination, supremacy principles dictate that the Bankruptcy Code must control. *See In re SPM Mfg.*, 163 B.R. at 420. Accordingly, the bankruptcy judge had the power to equitably subordinate the appellants' claims notwithstanding the fact that the claims were created by operation of Delaware state law.

C. Harm to Envirodyne's Other General Unsecured Creditors

Finally, the appellants argue that their claims should not be equitably subordinated because equitable subordination will not benefit Envirodyne's other unsecured creditors. Envirodyne's reorganization plan entitles all general unsecured creditors to 32.28 shares of common stock for each $500 of allowed claim. The appellants contend that these creditors will receive the same 32.28 shares of stock whether or not the appellants' claims are treated equally.

The appellants' argument must be rejected. All parties concede that Envirodyne's general unsecured creditors have not

been paid in full. In fact, the unsecured creditors have received substantially less than envisioned because of the unexpected drop in the market value of the stock. If the appellants are afforded the same priority as Envirodyne's general unsecured creditors, Envirodyne's stock will be diluted and the value of all shares will decrease. Appellants App., p. 31¶ 21. Accordingly, Envirodyne's other general unsecured creditors will be economically harmed by affording the appellants equal priority notwithstanding the fact that the other creditors will receive the same number of shares.

CONCLUSION

The judgment of the bankruptcy court is affirmed.

ENTER:

s/ Suzanne B. Conlon
Suzanne B. Conlon
United States District Judge

June 20, 1995

APPENDIX C — MEMORANDUM OPINION OF THE UNITED STATES BANKRUPTCY COURT FOR THE NORTHERN DISTRICT OF ILLINOIS DATED JANUARY 20, 1995

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

Chapter 11
Case Nos. 93 B 310
93 B 312
93 B 313
93 B 314
93 B 315
93 B 316
93 B 318
93 B 319

(Jointly Administered)
Hon. John D. Schwartz
Docket Under 93 B 319

Adv. No. 94 A 01227

In re:

ENVIRODYNE INDUSTRIES, INC.,
SANDUSKY PLASTICS, INC.,
SANDUSKY PLASTICS OF DELAWARE, INC.,
VISKASE CORPORATION,
VISKASE HOLDING CORPORATION,
VISKASE SALES CORPORATION,
CLEAR SHIELD NATIONAL, INC.
ENVIRODYNE FINANCE COMPANY

Debtors.

Appendix C

ENVIRODYNE INDUSTRIES, INC.

Plaintiff,

v.

AMERICAN EXPRESS, et als.,

Defendants.

MEMORANDUM OPINION
CROSS MOTIONS FOR SUMMARY JUDGMENT

The matters before the court are the cross motions for summary judgment of Defendant State of California and Plaintiff Envirodyne Industries, Inc. ("Envirodyne" or "Debtor" or "Plaintiff"). In this adversary proceeding, Envirodyne seeks to equitably subordinate those shareholders of pre-merger Envirodyne who have not tendered or otherwise redeemed their stock after pre-merger Envirodyne merged with Emerald Sub in 1989 or anytime subsequent thereto. The Defendants, the State of California, along with Defendants Seymour J. Ryckman; David B. Bloom; Jerry M. Friedman, as custodian for Jennifer Friedman; Jerry M. Friedman, as custodian for Julie Friedman; Jerry M. Friedman, as custodian for Mark Friedman; Anton J. Matijevic; H. Matijevic Industries; Joesph Matijevic; James A. Null; Bernie R. Prusak; Harvey M. Schmidt; and Illinois Department of Financial Institutions, all of whom have joined the State of California's motion (the defendants shall hereinafter be collectively referred to as "Defendants"), assert, as unsecured creditors of the Debtor, that since they did not engage in fraudulent, or any other wrongful, conduct, then Envirodyne may not equitably subordinate them to its general unsecured

creditors. The Defendants therefore should be entitled to the same distribution that the other general unsecured creditors received in the Envirodyne bankruptcy proceeding. Envirodyne maintains that fraudulent conduct is not necessary to subordinate the Defendants pursuant to § 510(c).[1] Further, it would be inequitable to its general unsecured creditors not to subordinate the claims of the Defendants, as the origin of each of the Defendants' claims was equity, not debt. For the reasons stated below, the court shall deny the defendants' motion for summary judgment and grant Envirodyne's cross motion for summary judgment.

SUMMARY OF THE UNDISPUTED FACTS

Local Rule 12(m)[2] of the Bankruptcy Rules of the United

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1. Unless otherwise indicated, all section references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1330.

2. On February 4, 1985, the full bankruptcy court met in executive session and with the approval of the United States District Court for the Northern District of Illinois, issued a General Order applying the "General Rules of the United States District Court for the Northern District of Illinois," *as amended form time to time, but with the amendments and provisos described in the General Order*, as the "General Rules and Civil Rules of this United States Bankruptcy Court." (Hereinafter designated as the "Old Local Bankruptcy Rules.") Some of the Old Local Bankruptcy Rules have since been amended.

On June 24, 1994, the District Court promulgated an entirely new set of "Local Bankruptcy Rules," effective July 11, 1994 at 12:01 a.m., and applied them to all pending cases. (Hereinafter referred to as the "New Local Bankruptcy Rules.") Because the Motion was filed and the briefing schedule was set before the New Local Rules became effective, the court cites the Old Local Bankruptcy Rules as part of its disposition of the Motion. The difference in the rules does not affect the outcome of this Motion.

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States District Court for the Northern District of Illinois require the moving party to file a detailed statement of material facts as to which there are no genuine issue. The party opposing the motion is required by Rule 12(n) to file a response to the movant's statement and set forth any facts which require denial of summary judgment. Both parties have made filings in conformance with the above standards and agree upon the following statement of facts:

The undisputed facts to this proceeding have been previously set forth by this court. *See In re Envirodyne Indus., Inc.*, 1993 WL 566565 at *7-13 (Bankr. N.D. Ill. 1993) (Findings of Fact and Conclusions of Law) and *In re Emerald Acquisition Corp.*, 170 B.R. 632, 637-8 (Bankr. N.D. Ill. 1994). Accordingly, the court shall only recite those facts germane to this proceeding.

In 1989, Emerald Acquisition Corporation ("Emerald") was created for the purpose of acquiring Envirodyne Industries, Inc. ("Former Envirodyne"). Emerald Sub One, Inc. ("Emerald Sub"), a wholly owned subsidiary of Emerald, was organized for the purpose of making an offer to purchase the outstanding shares of common stock of Former Envirodyne. In conjunction with a leveraged buyout ("LBO Transaction"), Emerald Sub purchased the tendering shares of Former Envirodyne at $40 per share and Former Envirodyne was merged into Emerald Sub, with current Envirodyne being the surviving entity.

The merger of these entities, both Delaware corporations, was made in accordance with Sections 253 and 262 of the Delaware General Corporation Law ("DGCL"). As of the effective date of the merger, June 1, 1989, the stock of Former Envirodyne was canceled. The shareholders of Former Envirodyne had the right to redeem their shares at $40 per share

or to dissent from the merger and obtain an appraisal in accordance with Delaware General Corporation Law. (Agreement of Merger, § 2.02). Former Envirodyne shareholders who failed to respond to the tender offer ceased to be equity holders and became creditors of Envirodyne, entitled to receive $40 per share, without interest, upon demand. (Agreement of Merger, § 2.02). Each of the Defendants is a nontendering shareholder, a representative thereof, or a successor in interest thereof. None of the Defendants dissented from the merger and therefore the right of appraisal is not available.

On January 6, 1993, an involuntary bankruptcy petition was filed against Envirodyne. The next day, Envirodyne's subsidiaries filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code and Envirodyne consented to the entry of an order of relief in the involuntary case. During the period prior to the commencement of this case, Envirodyne's consolidated balance sheet showed an accrued current liability of $2,176,000 due to cashed out former shareholders. On September 23, 1993, the Debtor's commenced this adversary proceeding, seeking to equitably subordinate the Defendants' claims to those held by Envirodyne's other general unsecured creditors, pursuant to § 510(c). Under the Debtors' First Amended Joint Plan of Reorganization as Twice Modified ("Plan"), the general unsecured creditors have received 32.28 shares of common stock in reorganized Envirodyne for each $500 amount of allowed claim. The Defendants have not received a distribution. At the time of the Disclosure Statement, Envirodyne estimated that this distribution would allow each general unsecured claimant to recover approximately two-thirds of the allowed amount of its respective claim. *See* Second Supplement to Debtors' First Amended Disclosure Statement

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Pursuant to Section 1125 of the Bankruptcy Code dated as of October 25, 1993 at 10. Since confirmation of the Plan, the trading price of Envirodyne's stock is lower then what was estimated at the time the Plan was confirmed. *See* Affidavit of Gordan S. Donovan, ¶ 15 (Donovan is the Treasurer and Secretary of Envirodyne). Accordingly, the general unsecured creditors were not, and have not, been paid in full. Therefore, the Defendants have not received a distribution under the Plan.

JURISDICTION

These motions are before the court pursuant to 28 U.S.C. § 157, and are referred here under Local District Rule 2.33. This court has subject matter jurisdiction under 28 U.S.C. § 1334, and this is a core proceeding under 28 U.S.C. § 157(b)(1).

SUMMARY JUDGMENT STANDARDS

Summary judgment is appropriate only "if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c) (adopted by Fed. R. Bankr. Pro. 7056). The primary purpose for granting a summary judgment motion is to avoid unnecessary trials when there is no genuine issue of material fact in dispute. *Trautvetter v. Quick*, 916 F.2d 1140, 1147 (7th Cir. 1990); *Farries v. Stanadyne/Chicago Div.*, 832 F.2d 374, 378 (7th Cir. 1987) (*quoting Wainwright Bank & Trust Co. v. Railroadmen's Federal Sav. & Loan Ass'n of Indianapolis.*, 806 F.2d 146, 149 (7th Cir. 1986)).

The burden is on the moving party to show that no genuine

issue of material fact is in dispute. *Anderson v. Liberty Lobby*, 477 U.S. 242, 248 (1986); *Matsushita Elec. Indus. Co., Ltd. v. Zenith Radio Corp.*, 475 U.S. 574, 585-86 (1986); *Celotex Corp. v. Catrett*, 477 U.S. 317, 322 (1986). A party seeking summary judgment always bears the initial responsibility of informing the court of the basis for its motion, and must identify those portions of the "pleadings, depositions, answers to interrogatories, and affidavits, if any," which it believes demonstrate the absence of a genuine issue of material fact. *Celotex*, 477 U.S. at 323. However, once the motion for summary judgment is made and supported as described above, Rule 56(e) provides that a party opposing the motion may not rest upon the mere allegations or denials in his pleading; the response of that party must set forth specific facts showing that there is a genuine issue for trial. *Celotex*, 477 U.S. at 324; *Anderson*, 477 U.S. at 248; *Matsushita*, 475 U.S. at 587; *Randle v. LaSalle Telecommunications, Inc.*, 876 F.2d 563, 567 (7th Cir. 1989); *Patrick v. Jasper County*, 901 F.2d 561, 564-66 (7th Cir. 1990).

On a summary judgment motion, the inferences to be drawn from the underlying facts must be viewed in the light most favorable to the party opposing the motion. *Anderson*, 477 U.S. at 255; *Matsushita*, 475 U.S. at 586; *Billups v. Methodist Hosp. of Chicago*, 922 F.2d 1300, 1302 (7th Cir. 1991); *Karazanos v. Navistar Int'l Transp. Corp.*, 948 F.2d 332, 335 (7th Cir. 1991). However, the existence of a material factual dispute is sufficient only if the disputed fact is determinative of the outcome under applicable law. *Anderson*, 477 U.S. at 248; *Howland v. Kilquist*, 833 F.2d 639, 642 (7th Cir. 1987).

The Court should not "weigh the evidence." *Anderson*, 477 U.S. at 249; *Illinois Bell Telephone Co. v. Haines and Company, Inc.*, 905 F.2d 1081, 1087 (7th Cir. 1990), *vacated on other*

grounds, 499 U.S. 944 (1992). However, "[i]f evidence opposing summary judgment is merely colorable or is not significantly probative, summary judgment may be granted." *Anderson*, 477 U.S. at 249-250, *Trautvetter*, 916 F.2d at 1147. When the record taken as a whole could not lead a rational trier of fact to find for the non-moving party, there is no genuine issue for trial and summary judgment should be granted. *Matsushita*, 475 U.S. at 587.

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When each side seeks summary judgment, that does not by itself indicate that there are no genuine issues of material fact. The court must rule on each motion separately in determining whether or not each judgment should be entered, in accordance with applicable principles. *ITT Indus. Credit Co. v. D.S. America, Inc.*, 674 F.Supp. 1330, 1331 (N.D. Ill. 1987) (Shadur, J.); District 12, *United Workers of Am. v. Peabody Coal, Co.*, 602 F. Supp. 240, 242 (S.D. Ill. 1985); *In re Woodstock Assocs. I, Inc.*, 120 B.R. 436, 442 (Bankr. N.D. Ill. 1990). See C. Wright, A. Miller & M. Kane, Federal Practice and Procedure §2720 (2d ed. 1983 & Supp. 1987). Cross motions for summary judgment do not require the court to decide the case on those motions. The court can deny both motions if both parties fail to meet their burden. *ITT*, 674 F.Supp. at 1331; *Wolf v. Maryland Casualty Co.*, 617 F. Supp. 456, 458 (S.D. Ill. 1985). See C. Wright, A. Miller & M. Kane, Federal Practice and Procedure §2720 (2d ed. 1983 & Supp. 1987).

In this adversary proceeding, the parties, and the court, agree that the issue before the court is solely one of law. Therefore, the prevailing party shall be entitled to summary judgment.

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DISCUSSION

Envirodyne's request to equitably subordinate the nontendering shareholders of a short form merger executed pursuant to DGCL § 253 is one of first impression. Under Section 510(c), a court may:

> (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or
>
> (2) order that any lien securing such a subordinated claim be transferred to the estate.

The vast majority of courts, applying the test in *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692, 700 (5th Cir. 1977), require either fraudulent or wrongful conduct on the part of the claimant before utilizing § 510(c). *In re Fabricators, Inc*, 926 F.2d 1458, 1464 (5th Cir. 1991); *In re Mansfield Tire & Rubber Co.*, 942 F.2d 1055, 1061 (6th Cir. 1991), *cert. denied* 112 S.Ct. 1165 (1992); *In re Bill Cullen Electric Contracting Co.*, 156 B.R. 235 (Bankr. N.D. Ill. 1993).

However, in recent cases, courts have used § 510(c) to equitably subordinate the holders of both tax penalty claims and claims originating from a stock redemption, despite the absence of any wrongdoing on the part of such claimants. *See In re Burden*, 917 F.2d 115, 116-118 (3rd Cir. 1990); *Schultz Broadway Inn v. United States*, 912 F.2d 230, 232 (8th Cir. 1990);

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In re Vitreous Steel Products Co., 911 F.2d 1223, 1237 (7th Cir. 1990); *In re Virtual Network Services Corp.*, 98 B.R. 343 (N.D. Ill. 1989), *aff'd* 902 F.2d 1246, 1249-50 (7th Cir. 1990); *In re SPM Manufacturing Corp.*, 163 B.R. 411, 413-416 (Bankr D. Mass. 1994). Relying on the legislative history of §510(c), as well as the vague language of § 510(c), these courts have refused to imply a wrongful conduct requirement into § 510(c). Further, in tax penalty cases, failing to equitably subordinate the holders of tax penalty claims would penalize the general unsecured creditors for misconduct by a debtor. *Schultz Broadway*, 912 F.2d at 233-4; *Virtual Network*, 902 F.2d at 1250. In *SPM Manufacturing*, a stock redemption case, § 510(c) was used to subordinate a claim in which there was neither misconduct by a claimant nor by the debtor. *SPM Manufacturing*, 163 B.R. at 411-412. Relying on *Virtual Network* and *Burden*, the *SPM* court held that there was no misconduct requirement in § 510(c) and equitable subordination was appropriate solely because of the origin of the claim. *SPM Manufacturing*, 163 B.R. at 411-412.

It is the approach in *SPM Manufacturing* that Envirodyne asks this court to adopt. It readily acknowledges that there was no wrongful or fraudulent conduct on the part of the Defendants. If misconduct was a requirement to impose § 510(c), the Defendants' motion for summary judgment would be granted. Instead, Envirodyne requests that this court follow the lead of the Seventh Circuit and not require misconduct on the part of the claimant as a prerequisite for subordinating a claim under § 5lO(c). Envirodyne argues that, after examining the origins of the Defendants' claims, its use of § 510(c) in the Plan was appropriate. Although legally, the Defendants were creditors of the Debtor's estate, holding valid claims, Envirodyne maintains that since their claims arose on account of their stock ownership in Former Envirodyne, the Defendants should not be afforded the

same priority as its general unsecured creditors. Envirodyne is not attempting to treat the Defendants as equity holders of Envirodyne. The Defendants would be entitled to be paid in full from any remaining assets of Envirodyne, to the extent such exist, before any distribution could be made to Envirodyne's equity holders. Rather, Envirodyne seeks to subordinate the shareholders of Former Envirodyne to Envirodyne's general unsecured creditors.

I. *Applicable Standard for Applying § 510(c)*

The phrase "under principles of equitable subordination" is not defined by the Bankruptcy Code nor can its meaning be definitively deciphered from the legislative history of § 510(c). *See Virtual Network*, 98 B.R. at 343; *Burden*, 917 F.2d at 115. As a result, the portion of the legislative history that a party relies upon depends on its position in a particular case. *See Virtual Network*, 98 B.R. at 343 (containing a thorough discussion of the legislative history of § 510(c); *but see* Scott M. Browning, Note, *No Fault Equitable Subordination: Reassuring Investors That Only Government Penalty Claims Are At Risk*, 34 William & Mary L. Rev. 487 (1993) (arguing for a return to the *Mobile Steel* standard by criticizing *Virtual Network* and its progeny).

As previously stated, in the vast majority of cases, in order to apply § 510(c), the party seeking to impose § 510(c) must satisfy the *Mobile Steel* test. Proponents of the *Mobile Steel* test contend that § 510(c) codified the existing case law on equitable subordination. This view finds support in the following fragment of the legislative history:

> that any subordination ordered under this provision must be based on principles of

> equitable subordination. These principles are defined by case law, and have generally indicated that a claim may normally be subordinated only if its holder is guilty of misconduct. As originally introduced, the bill provided specifically that a tax claim may not be subordinated on equitable grounds. The bill deletes this expression, but the effect of the amendment should be much the same in most situations since, under the judicial doctrine of equitable subordination, a tax claim would rarely be subordinated.

S.Rep. No. 989, 95th Cong., 2d Sess. 74 (1978), reprinted in, 1978 U.S. Code & Cong. Admin. News 5787, 5860.

The Defendants, arguing that § 510(c) should be narrowly construed, assert that this statement is proof of Congress' intent to codify the *Taylor*[3], *Pepper*[4], and *Comstock*[5] trilogy, as interpreted by *Mobile Steel*, all of which required some form of inequitable conduct by the creditor before equitably subordinating such creditor. *See* Browning, 34 William & Mary L. Rev. at 492-494.

However, the legislative history pendulum swings both ways in this case. Recently, especially in the Seventh Circuit,

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3. *Taylor v Standard Gas & Electric Co.*, 306 U.S. 307 (1939).

4. *Pepper v. Litton*, 308 U.S. 295 (1939).

5. *Comstock v. Group of Institutional Investors*, 335 U.S. 211 (1948).

another portion of the legislative history has been cited to support the Debtor's position that wrongful or inequitable conduct is not required in order to equitably subordinate a creditor. The following statements by Representative Edwards and Senator DeConcini support a more expansive view of § 510(c), stating that this section:

> represents a compromise between similar provisions in the House bill and Senate amendment. * * * It is intended that the term "principles of equitable subordination" follow existing case law and leave to the courts development of this principle. To date, under existing law, a claim is generally subordinated only if [the] holder of such claim is guilty of inequitable conduct, or the claim itself is of a status susceptible to subordination, such as a penalty or a claim for damages arising from the purchase or sale of a security of the debtor. * * *

124 Cong.Rec. H11, 089—H11, 117 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards); id., S17,403—S17,434 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini), reprinted in, 1978 U.S. Code & Cong. Admin. News 5787, 6452, 6521.

Courts adopting this viewpoint maintain that Congress intended the phrase "under the principles of equitable subordination" to be a fluid concept. *Schultz*, 912 F.2d at 232; *Virtual Network*, 98 B.R. at 347; *SPM Manufacturing*, 163 B.R. at 414. Courts with this perspective must determine, on a case by case basis, whether it is appropriate, considering the equities of the case, to subordinate a class of unsecured creditors to another such class

of unsecured creditors, despite the lack of inequitable conduct by either class. *Virtual Network*, 902 F.2d at 1250; *Vitreous Steel*, 911 F.2d at 1237; *Burden*, 917 F.2d at 120. This has been labelled as the "no fault equitable subordination" test. *See* Browning, 34 William & Mary L. Rev. at 492-494.

In his article, Browning foresees catastrophic consequences of this new test. He fears that bankruptcy courts will cavalierly subordinate claims of creditors based on an individual bankruptcy court's notion of fairness. *Id.* at 518. As a result, lenders will be unable to assess risk and that the security of creditors will be endangered. *Id.* at 487, 518. These doomsday predications regarding the ramifications of no fault equitable subordination have thus far not come into fruition. Courts have not returned the law to a position in which fairness is the only guideline for applying the principles of equitable subordination. *See Id.* Courts have not applied the doctrine of no fault equitable subordination except in tax penalty cases, *Burden*, 917 F.2d at 120 and *Virtual Network*, 902 F.2d at 1250, punitive damages cases, *In re Colin*, 44 B.R. 806, 810 (Bankr. S.D.N.Y. 1984) and *In re Johns-Manville Corp.*, 68 B.R. 618 (Bankr. S.D.N.Y. 1986), *aff'd in part, rev'd in part*, 78 B.R. 407 (S.D.N.Y. 1987), *aff'd* 843 F.2d 636 (2nd. Cir. 1988) and a stock redemption case, *SPM Manufacturing*, 163 B.R. at 414.

Neither the security of creditors nor the policy of the Bankruptcy Code have been undermined. In these scenarios, it was deemed unfair to the unsecured creditors not to equitably subordinate the claims of the Internal Revenue Service and the holders of punitive damage claims, respectively, because of wrongdoing by the debtor. *Virtual Network*, 902 F.2d at 1250 (tax penalties) and *Johns-Manville*, 68 B.R. at 627 (punitive damages). In the case of a stock redemption, the court looked at

the substance of the transaction, as opposed to its form, in deciding to equitably subordinate the claims of a former shareholder, turned creditor, to the claims of the general unsecured creditors. *SPM Manufacturing*, 163 B.R. at 414. While neither the tax penalty, or punitive damage, line of cases are directly applicable to the case before the court, the stock redemption case is instructive.

Historically, courts have not hesitated to equitably subordinate former shareholders who have redeemed their stock to the issuing corporation and received debt in its stead. *See Robinson v. Wangemann*, 75 F.2d 756, 757 (5th Cir. 1935); *SPM Manufacturing*, 163 B.R. at 415; *Liebowitz v. Columbia Packing Co.*, 56 B.R. 222 (D. Mass. 1985), *aff'd* 802 F.2d 439 (1986). A transaction, such as a stock redemption, by which a corporation acquires its own stock for a sum of money is not a sale. *Robinson*, 75 F.2d at 757. Accordingly, after a stock redemption, the former stockholder, while a creditor, would not stand on equal footing with trade or general creditors should the corporation become bankrupt. *Liebowitz*, 56 B.R. at 224, *citing Matthews Bros. v. Pullen*, 268 F. 827, 828 (1st Cir. 1920). An entity that becomes a "creditor" of the corporation after a stock redemption is not a true creditor in that it never lent money to the corporation. *Robinson*, 75 F.2d at 757. As a stock redemption is merely a means of distributing a proportion of the corporation's assets to the stockholder, the debt received, in the form of a promissory note or otherwise, by the former shareholder does not act to change the underlying character of a transaction, although on the corporation's books, the liability is a debt, not equity. An entity or person that accepts a debt instrument in lieu of cash in a stock redemption transaction assumes the risk that the corporation will remain solvent until the note is due. *Liebowitz*, 56 B.R. at 224. Therefore, despite the absence of impropriety by the former

shareholder, it is not inequitable or unfair to subordinate the claims of such a former shareholder to those claims of the general unsecured creditors. *Id.*; *Weisman v. Goss (In re The Hawaii Corp.)*, 694 F.2d 179, 180-1 (9th Cir. 1982); *SPM Manufacturing*, 163 B.R. at 415; *Liebowitz*, 56 B.R. at 224.[6]

Envirodyne argues, based on the stock redemption cases discussed above, that it should not be required to show misconduct on the part of the Defendants in order to subordinate them pursuant to § 510(c). Naturally, the Defendants maintain that this court should strictly adhere to the test set forth in *Mobile Steel* since a stock redemption is not the equivalent of a short form merger. It is clear, at least in the Seventh Circuit, when determining the treatment of two classes of unsecured creditors in a plan of reorganization, it is not necessary to determine whether one of the classes has engaged in wrongful conduct. Accordingly, Envirodyne shall not be required to show wrongful conduct in order to show that its subordination of the Defendants' claims pursuant to § 510(c) was proper. Whether the Plan proposed by Envirodyne and approved by this court properly subordinated the Defendants shall be discussed below.

II. *Section 510(c) and DGCL § 253*

The underlying theme of the Bankruptcy Code is equality of distribution. *Mobile Steel*, 563 F.2d at 698) ("equality of distribution is the underling theme of the Bankruptcy Act"). Bankruptcy courts have a broad range of powers in determining

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6. The court notes that this view is not uniform. In *In re Stern-Slegman-Prins Co.*, 86 B.R. 994, 1000 (Bankr. W.D. Mo. 1988), stock redemption debt was not subordinated on equitable grounds because of the lack of misconduct on the part of the claimant.

whether to subordinate claims. *Stern-Slegman*, 86 B.R. at 944, *citing Pepper*, 308 U.S. at 303-311. One of these powers, as stated in *Virtual Network* and by Congress in the legislative history of § 510(c), is to develop the meaning of the phrase "under principles of equitable subordination." *Virtual Network*, 98 B.R. at 349. Neither Envirodyne nor the Defendants nor the court could locate any cases discussing the subordination of a creditor class consisting of the nontendering shareholders remaining from a short form merger. Envirodyne argues that it is a reasonable extrapolation of the stock redemption cases to subordinate the nontendering shareholders of a short form merger. A short explanation of a short form merger under Delaware law, codified as DGCL § 253, is necessary prior to considering Envirodyne's arguments.

DGCL Section 253 provides that:

> (a) In any case in which at least 90% of the outstanding shares of each class of the stock of a corporation or corporations is owned by another corporation and 1 of the corporations is a corporation of this State and the other or others are corporations of this State, or any other state or states, or the District of Columbia and the laws of the other state or states, or the District permit a corporation of such jurisdiction to merge with a corporation of another jurisdiction, the corporation having such stock ownership may either merge the other corporation or corporations into itself and assume all of its or their obligations, or merge itself, or itself and 1 or more of such other corporations, into 1 of the

other corporations by executing, acknowledging and filing, in accordance with s 103 of this title, a certificate of such ownership and merger setting forth a copy of the resolution of its board of directors to so merge and the date of the adoption; provided, however, that in case the parent corporation shall not own all the outstanding stock of all the subsidiary corporations, parties to a merger as aforesaid, the resolution of the board of directors of the parent corporation shall state the terms and conditions of the merger, including the securities, cash, property, or rights to be issued, paid, delivered or granted by the surviving corporation upon surrender of each share of the subsidiary corporation or corporations not owned by the parent corporation. If the parent corporation be not the surviving corporation, the resolution shall include provision for the pro rata issuance of stock of the surviving corporation to the holders of the stock of the parent corporation on surrender of any certificates therefor, and the certificate of ownership and merger shall state that the proposed merger has been approved by a majority of the outstanding stock of the parent corporation entitled to vote thereon at a meeting duly called and held after 20 days' notice of the purpose of the meeting mailed to each such stockholder at his address as it appears on the records of the corporation if the parent corporation is a

corporation of this State or state that the proposed merger has been adopted, approved, certified, executed and acknowledged by the parent corporation in accordance with the laws under which it is organized if the parent corporation is not a corporation of this State. A certified copy of the certificate shall be recorded in the office of the recorder of the county in this State in which the registered office of each constituent corporation which is a corporation of this State is located. If the surviving corporation exists under the laws of the District of Columbia or any state or jurisdiction other than this State, subsection (d) of s 252 of this title shall also apply to a merger under this section.

(b) If the surviving corporation is a Delaware corporation, it may change its corporate name by the inclusion of a provision to that effect in the resolution of merger adopted by the directors of the parent corporation and set forth in the certificate of ownership and merger, and upon the effective date of the merger, the name of the corporation shall be so changed.

(c) Subsection (d) of s 251 of this title shall apply to a merger under this section, and subsection (e) of s 251 of this title shall apply to a merger under this section in which the surviving corporation is the subsidiary

corporation and is a corporation of this State. References to "agreement of merger" in subsections (d) and (e) of s 251 of this title shall mean for purposes of this subsection the resolution of merger adopted by the board of directors of the parent corporation. Any merger which effects any changes other than those authorized by this section or made applicable by this subsection shall be accomplished under s 251 or s 252 of this title. Section 262 of this title shall not apply to any merger effected under this section, except as provided in subsection (d) of this section.

(d) In the event all of the stock of a subsidiary Delaware corporation party to a merger effected under this section is not owned by the parent corporation immediately prior to the merger, the stockholders of the subsidiary Delaware corporation party to the merger shall have appraisal rights as set forth in s 262 of this title.

(e) A merger may be effected under this section although 1 or more of the corporations parties to the merger is a corporation organized under the laws of a jurisdiction other than 1 of the United States; provided that the laws of such jurisdiction permit a corporation of such jurisdiction to merge with a corporation of another jurisdiction.

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This section empowers a parent corporation to unilaterally merge with its subsidiary and to pay the subsidiary's minority shareholders for their shares, provided that the parent owns 90% of the outstanding shares of each class of stock of the subsidiary corporation. Ernest L. Folk, III, Rodman Ward, Jr. and Edward P. Welch, *Folk on the Delaware General Corporation Law*, § 253.1 (3rd. ed. 1993 Supp.). The merger becomes effective when a certificate setting forth a copy of the merger resolution by the parent's board and the fact that the parent owns 90% or greater of the subsidiary is properly confirmed. *Id.* In the event the subsidiary is not wholly owned and it is the entity that survives, the resolution of merger must state the terms and conditions of the merger, including the consideration to be paid by the surviving corporation to the minority shareholders upon the surrendering of their shares. *Id.* Barring fraud or breach of fiduciary duty, appraisal under DGCL § 262 is the only remedy available to the minority shareholders. *Id, citing Braasch v. Goldschmidt*, 199 A.2d 760, 764 (Del. Ch. 1964). *See also Najjar v. Roland Int'l Corp.*, 387 A.2d. 709 (Del. Ch. 1978), *aff'd* 407 A.2d 1032 (1979).

The parties in this action do not dispute that DGCL § 253 was complied with and that none of the Defendants asserted their rights of appraisal. In addition, it is not contested that the Defendants are statutory creditors of the Envirodyne, as minority shareholders of Former Envirodyne. The only remaining issue in this action is where in the priority scheme set forth by the Bankruptcy Code should these Defendants be placed.

Envirodyne maintains that while the Defendants hold valid claims against the estate, as shareholders of Former Envirodyne, they are akin to a former shareholder who accepted debt in lieu of

cash in a stock redemption transaction. That the Defendants never held Envirodyne stock is irrelevant. Envirodyne contends that, by failing to either assert their appraisal rights or timely redeem their shares after the merger, the Defendants have assumed a position similar to that of an entity that becomes creditor after exchanging its stock for debt in a stock redemption transaction. As those who receive debt in a stock redemption are subordinated to a debtor's general unsecured creditors, so should the Defendants who failed to timely tender their shares after a short form merger. The court concurs. To hold otherwise would allow substance to control over form. At the time the Defendants entered into their relationship with Former Envirodyne, they did not have any guarantees that they would recover their investment. They invested in Former Envirodyne with the hope of sharing in its future earnings but with the risk that they may lose their investment in the event that the company fails or performs poorly. Contrast this with the position of a general unsecured creditor. When a supplier extends credit, it does so with the reasonable expectation that it will be repaid in due course for the goods or services that it provided. Conversely, regardless of how the company performs, it does not expect to share in any profits. A creditor does not subject itself to the risks of a shareholder.

After a short form merger, shareholders who do not tender their shares become creditors of the new company. The question becomes whether these "creditors" should be treated on a *pari passu* basis with the general unsecured creditors of the new company in the event the new company files a Chapter 11 petition before these "creditors" tender their shares. The Defendants argue that this is precisely the treatment that should be afforded them. The law does not distinguish a creditor by the origins of its claim and neither should this court.

However, Envirodyne argues, and the court agrees, that, as a court of equity, the bankruptcy court has an obligation to ensure that all creditors are treated fairly. The fundamental aim of equitable subordination is to undo or offset any inequity in the claim position of a creditor that will produce unfairness to other creditors in terms of bankruptcy results. *Virtual Network*, 98 B.R. at 350, *citing In re Kansas City Journal-Post Co.*, 144 F.2d 791, 800 (8th Cir. 1944). The equitable subordination doctrine focuses on the nature of the bankrupt's estate, not on the conduct of the claimant who may be subordinated. *Virtual Network*, 98 B.R. at 350. The Defendants, although legally creditors, are in essence former equity holders who never took the time to tender their shares. Therefore, they are not entitled to the same distribution as an ordinary creditor in a plan of reorganization. The Defendants never lent money to the corporation nor do they share any other characteristic of an ordinary creditor. They took certain risks when they purchased the stock of Former Envirodyne. That they became creditors of Envirodyne because they failed to timely tender their shares should not elevate their status to that of an ordinary creditor. Similar to a former shareholder who accepts a promissory note in exchange for its stock, by failing to tender their shares in the three and one-half years between the short form merger and the filing of Envirodyne's bankruptcy case, the 21 Defendants assumed the risk that Envirodyne would remain solvent. *See Liebowitz*, 56 B.R. at 224. When Envirodyne fell into bankruptcy, the Defendants' ability to tender their shares became subject to the provisions of the Bankruptcy Code, including § 510(c).

In deciding to subordinate the Defendants' claims pursuant to § 510(c), the court has noted the similarity between a stock redemption and a short form merger. The court is not persuaded by the Defendants' argument that the stock redemption cases

relied upon by Envirodyne were essentially two party transactions between the debtor and the former shareholder. In addition, that each of the former shareholders in the stock redemption cases voluntarily choose to sell their shares back to the issuing corporation is similarly not alluring. Such distinctions endorse form over substance. Although legally creditors, these Defendants are in reality displaced equity holders. While losing their rights as equity holders after the merger, the court cannot ignore the fact that the Defendants' claims arose, initially, because the Defendants choose to become equity holders and assumed the risks of becoming such. That a short form merger changed their status from equity holder to creditor is of no consequence when comparing their rights to the Debtor's general unsecured creditors. As a result, the Defendants shall not be entitled to payment unless and until the general unsecured creditors have been paid in full. After failing to assert their appraisal rights, the Defendants had over three years to tender their shares. It would not be fair or equitable to treat such a class on par with the general unsecured creditors. Therefore, Envirodyne properly subordinated the Defendants' claims pursuant to § 510(c) in the Plan.[7]

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7. That the merger transaction was valid under state law and that the Defendants' are creditors of Envirodyne does not affect this court's decision to equitably subordinate the Defendants. The Defendants were equitably subordinated pursuant to the principles and policies of the Bankruptcy Code, not state law.

Appendix C

CONCLUSION

The Defendants' motion for summary judgment shall be denied and Envirodyne's cross motion for summary judgement shall be granted. Envirodyne's Plan properly subordinated the claims of the Defendants to those claims of Envirodyne's general unsecured creditors.

ENTER:

Dated: 1/20/95

s/ John D. Schwartz
United States Bankruptcy Judge
John D. Schwartz